

**TESTIMONY OF**  
**ROBERT I. GULLEDGE**  
**CHAIRMAN/PRESIDENT/CEO**  
**OF**  
**CITIZENS BANK, INC.**  
**ROBERTSDALE, ALABAMA**  
  
**ON BEHALF OF THE**  
  
**INDEPENDENT COMMUNITY BANKERS OF AMERICA**  
  
**BEFORE THE**  
  
**FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE**  
**HOUSE FINANCIAL SERVICES COMMITTEE**  
**U.S. HOUSE OF REPRESENTATIVES**

**MARCH 13, 2001**

Mr. Chairman, Ranking member Waters, members of the Committee, my name is Robert I. Gulledge and I am Chairman/President/CEO of Citizens Bank, located in Robertsdale, Alabama. I am also Chairman of the Independent Community Bankers of America (ICBA)<sup>1</sup>, and I am pleased to appear here today on behalf of the more than 5,300 community banks across the nation that are members of the ICBA.

I am pleased to share with you the views of our nation's community bankers on the payment of interest on reserves maintained at Federal Reserves banks and the repeal of the prohibition of payment of interest on business checking accounts.

Chairman Bachus, I would first like to take this opportunity to thank you for your knowledge of and interest in community banking, and congratulate you on your selection to chair this important subcommittee. As the year unfolds, we look forward to working with you and other subcommittee members on issues crucial to our nation's community banks and the communities we serve.

**Repeal of the Prohibition of the Payment of Interest on Business Checking Accounts**

I will address the issue of interest on business checking accounts first. Mr. Chairman, as you know, this issue has been debated among community bankers for several years.

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<sup>1</sup> ICBA is the primary voice for the nation's community banks, representing 5,300 institutions at nearly 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than \$486 billion in insured deposits, \$592 billion in assets and more than \$355 billion in loans for consumers, small businesses and farms. They employ nearly 239,000 citizens in the communities they serve. For more information, visit [www.icba.org](http://www.icba.org).

Bankers are divided on whether or not the prohibition on paying interest should be repealed. Some bankers argue that lifting the prohibition is a way of increasing economic efficiency, simplifying business practices, remaining competitive and is needed to keep their best business customers. Others argue that lifting the prohibition could be very costly to some community banks because either the interest payments themselves are costly or simply because the transition into lifting the current prohibition would require the demobilizing of current alternative systems, which is a financial burden.

There are wide differences of opinion regarding the anticipated effects of repealing the prohibition. For example, one analysis prepared by a banker who is opposed to repealing the prohibition on paying interest on business checking accounts indicated that if the bank's customers moved \$20 million into interest bearing accounts at 5 ½ percent, the interest cost would be the equivalent of 17 cents per share, affecting the price of the institution's stock by \$2.38. Under this scenario, the bank would have to raise \$21,509,304 in additional deposits to offset the cost of moving the \$20 million in interest-free deposits to interest bearing accounts. This banker determined such a cost would be prohibitive.

By contrast, another banker supporting the repeal of the prohibition argued that the current prohibition has been competitively damaging to the banking industry, especially community banking. He said many brokerage firms and other non-bank competitors have and will more aggressively continue to compete directly with commercial banks to develop and expand small business relationships. If the banking industry is not allowed to be competitive in offering interest-bearing commercial checking accounts, community banks may become more vulnerable to losing their most important business deposit and loan customers to non-bank and money center financial services providers that are not constrained by banking prohibitions.

### **Compromise Proposed**

Mr. Chairman, ICBA has neither endorsed nor opposed lifting the prohibition on paying interest on business checking accounts. Rather, we have advocated an alternative that bankers on both sides of the issue tell us they can support. Under our compromise, the number of allowable transactions from money market deposit accounts (MMDA) would be increased to 24 per month, from the current limit of 6 per month, to enable banks to sweep funds between non-interest bearing commercial checking accounts and interest-bearing MMDA accounts on a daily basis. Thus, any bank that chose to pay interest on a commercial checking account would be able to do so using the "sweep" mechanism. But banks that choose not to offer interest would not be forced by competitive pressures to do so.

Mr. Chairman, as you know, the MMDA is a type of savings account that pays interest, and is available to businesses as well as other account holders. However, the law currently allows a maximum of six pre-authorized third-party withdrawals per month. Sweeps are arrangements between depository institutions and business customers that allow the institutions to transfer the businesses' checking account balances out of those

accounts each evening and put them into interest-bearing MMDA accounts. The next morning, the balances are transferred back into the business' checking accounts. Sweeps therefore give customers the advantage of accumulating interest on their balances when the balances are not in use.

The proposal to amend the law governing MMDA accounts to permit 24 transactions per month would enable community banks to remain competitive in providing cash management services to their commercial customers. It also would enable commercial customers to yield a return on the funds they have deposited with the bank, and it would not force community banks to move deposits to interest bearing accounts when their margins could be squeezed by such an action.

We urge the Committee to consider this alternative as a way to resolve a potentially divisive issue with community bankers.

### **Payment of Interest on Reserves Maintained at Federal Reserve Banks**

Let me now move to the proposal to require the Federal Reserve to pay interest on required and excess reserves depository institutions maintain as balances at Federal Reserve Banks, and discuss the impact of this proposal on community banks.

The Federal Reserve supports this proposal arguing that it could induce banks to increase their reserve balances. The Fed has stated that it is concerned that a steady continued decline in reserve balances could impair its ability to execute monetary policy. The reserves at the Fed have dropped significantly in recent years as required reserves have decreased and depository institutions have become more adept at managing their reserve balances. In fact, required reserve balances have dropped from around \$28 billion in 1993 to \$4 billion today.

One of the reasons for this precipitous decline in the reserve balance is that some financial institutions have been able to reduce the amount in their transaction accounts, against which reserves must be maintained, by sweeping funds into non-reservable, interest-bearing instruments at the end of each day. This is a practice that takes place mostly with larger financial institutions and not by smaller financial institutions such as community banks.

Currently, no reserves are required for reservable liabilities under \$5.5 million, while reservable liabilities between \$5.5 million and \$42.8 million are in the low reserve portion, subject to minimal reserves. When taking these levels into account, many community banks are not required to post substantial reserves. And many community banks can meet their required reserves with vault cash. If a smaller bank has no reserve requirements, or meets them directly through the use of vault cash (including cash at branches and ATM locations), or a combination of vault cash and reserve accounts, they do not stand to benefit directly from this proposal. They would not earn interest on reserves, because either they do not maintain a Fed reserve account or their balance is very small.

Another reason for the decline in reserve levels is the proliferation of deposit options available to bank customers. Customers are diversifying their funds by placing them in IRA's and 401(k)s and purchasing mutual funds, bonds or CDs. The availability of these options, coupled with ready access to these options through the Internet, has contributed to the steady decline in reservable deposits.

This deposit shift has been particularly harmful to community banks that rely on core deposits as their primary source of lendable funds. That is why the ICBA has advocated an increase in deposit insurance coverage levels as a means to keep more funds in local financial institutions for community lending purposes.

### **Little Benefit for Smaller Banks**

So you can see, Mr. Chairman, the interest on reserves proposal would have little, if any, direct monetary benefit for most community banks. Indeed, it is the larger depository institutions that would benefit most from such a proposal. According to a Federal Reserve analysis, almost all of the banks that would receive interest on required reserve balances would be distributed evenly among banks in the top three-fifths, ranked by total deposits, but the dollar payments would be heavily skewed to those banks in the top fifth. These findings were conveyed to our association (then called the Independent Bankers Association of America) in a letter from Donald L. Kohn, director of the Federal Reserve's Division of Monetary Affairs, dated October 21, 1998.<sup>2</sup> We had written the Federal Reserve to inquire whether it had done an analysis to quantify the benefits to large banks versus community banks if legislation that allowed the Fed to pay interest on reserves were enacted.

To illustrate, if a bank has \$50 billion in transaction accounts, that bank's reserve requirements would be nearly \$5 billion.<sup>3</sup> At an interest rate of 5%, the interest on that \$5 billion reserve balance held in a reserve account at a Federal Reserve bank would be \$250 million a year. By contrast, if a \$120 million bank has \$104 million in deposits, but only \$32 million of that amount is in reservable transaction accounts, the reserve requirement is \$960,000, all of which is satisfied by vault cash. Therefore, the smaller bank does not stand to earn any interest at all and therefore does not benefit from legislation that would require the Federal Reserve to pay interest on reserves maintained at Federal Reserve banks.

In fact, this holds true for most ICBA members since the average asset size of an ICBA member is \$108 million, with average domestic deposits of \$95 million, and average transaction account deposits of \$25 million. The reserve requirement for an average ICBA member, then, is \$750,000. Therefore, most ICBA members are clearly able to meet their reserve requirements using vault cash, which means they would most likely not maintain reserves at a Federal Reserve bank.

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<sup>2</sup> Letter to the Independent Community Bankers of America from Donald L. Kohn, director of the Federal Reserve's Division of Monetary Affairs, October 21, 1998.

<sup>3</sup> The reserve requirement is 3% of net transaction accounts up to \$46.5 million, plus 10% of any amount over \$46.5 million (12 CFR 204.9).

### **Role of Reserves in Monetary Control**

Central to the required reserves issue is the role of reserves in monetary control. We appreciate Federal Reserve Chairman Greenspan's concern that if the decline in reserves continues, it could have an effect on the Federal Reserve's ability to implement monetary policy and may have the potential to increase the volatility of the federal funds interest rates. We defer to Chairman Greenspan on this important issue.

In conclusion, legislation to require the payment of interest on reserves maintained at Federal Reserve banks would not benefit community banks directly. However, we understand the importance of the Federal Reserve's concern about maintaining monetary control and the role that the Federal Reserve System provides to our nation's community bankers. Therefore, we do not oppose the proposal to require the Fed to pay interest on sterile reserves.

### **Conclusion**

Thank you for the opportunity to testify on both issues regarding the payment of interest on sterile reserves held at Federal Reserve banks and the issue of the payment of interest on business checking accounts.

ICBA stands ready to work with you on these issues. I look forward to answering any questions you or other Subcommittee members may have.